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"BASELINE REFORM ACT" IS A STEP IN THE WRONG DIRECTION

By Richard Kogan

On January 24, the House Budget Committee passed legislation introduced by Chairman Paul Ryan (R-WI), Rep. Rob Woodall (R-GA), and other members that would require the Congressional Budget Office (CBO) and the Office of Management and Budget (OMB) to assume, in constructing budget "baselines" that project funding levels for future years, that future annual appropriations will remain frozen indefinitely, with no adjustment for inflation. This change could weaken, rather than strengthen, fiscal discipline and is ill-advised analytically.

Discretionary appropriations accounted for 38 percent of the federal budget in fiscal year 2011 and cover areas such as defense, education, law enforcement, housing, veterans' health, job training, transportation, health research and disease control, NASA, national parks and forests, and foreign assistance. Under longstanding budget rules, CBO and OMB assume that future discretionary appropriations will be at the same dollar levels as in the most recently enacted appropriations bills, adjusted for inflation. The reported legislation, the Baseline Reform Act (H.R. 3578), would remove the inflation adjustment and mandate that baselines henceforth assume funding will be frozen indefinitely. This would establish an unrealistic and misleading benchmark against which to measure changes in funding.

The Budget Control Act of 2011 imposed statutory caps on discretionary appropriations for all years through 2021. The most commonly cited budget projections for the next ten years consequently assume that discretionary spending will be at the cap amounts, rather than the inflation-adjusted levels, so changing the definition of the budget baseline may have little immediate impact. But the issues the proposal raises are important for the longer run.

Proposal Would Make Projections of Deficits and Debt Unrealistically Rosy and Could Weaken Budget Discipline

Removing inflation adjustments from budget projections for discretionary programs would make the projections of deficits and debt look more favorable than they really are, by creating an unrealistic assumption that policymakers will cut funding for discretionary programs in real terms every year through a permanent, across-the-board funding freeze, irrespective of the level of inflation.

The number of staff whose salaries and benefits are paid, the goods and materials that agencies purchase, and the services that programs provide all would be assumed to be cut every year under the baseline. This lack of realism could lead policymakers, the press, and the public to believe that deficits will be lower than is likely the case and thus to conclude that costly new proposals are more affordable than they actually are. This could also lessen pressure to enact the unpopular budget cuts and revenue increases that will be necessary over the coming decade to bring the budget to a sustainable and prudent long-term path.

To illustrate this point, note that last spring CBO compared a ten-year freeze in discretionary appropriations — both defense and non-defense — with its ten-year baseline, in which appropriations grow with inflation. Relative to the baseline, a freeze would reduce expenditures for these programs by $1.3 trillion over the next ten years. Counting the resulting interest savings, the deficit would appear $1.6 trillion lower than if discretionary programs simply grew with inflation. This extra room could suggest that the nation could afford $1.3 trillion in new tax cuts or expansions in mandatory programs.

Put differently, many people infer that baseline projections of deficits and debt constitute a prediction of how the budget will turn out. Although CBO and OMB explain that baselines are not intended to be predictions of likely outcomes, that misimpression remains. Accordingly, baselines should avoid unrealistically rosy policy assumptions.

This leads to the question of whether a ten-year funding freeze is plausible. History answers "no."

Data on discretionary expenditures go back to 1962.[1] We examined 39 ten-year periods, from 1962-1972 to 2000-2010, and found there was *not a single ten-year period in which total discretionary funding was frozen.*

To the contrary, the lowest ten-year nominal growth rate was 17 percent (an average of 1.6 percent per year) over 1989-1999. Moreover, that period was anomalous — defense spending shrank by 9 percent, largely due to the end of the Cold War and the collapse of the Soviet Union, which led the United States to substantially reduce its armed forces. Such a circumstance is very unlikely to occur twice. (Even including the defense drawdown from 1989-1999, defense grew at an average rate of 5.3 percent per year over the 39 ten-year periods we studied.)

Even a baseline that adjusts only for inflation, as the official baselines currently do, will likely understate future levels for discretionary programs, and so give too optimistic a picture of future deficits and debt. Adjusting only for inflation fails to account for the effect of growth in the size of the U.S. population, which is one reason that funding for discretionary programs has tended to grow faster than inflation. Making baseline rules significantly rosier could detract from fiscal discipline.

[1] Technically, the issue is not the level of expenditures but rather of funding (budget authority) for discretionary programs, but data on discretionary funding go back only to 1976. Because ten-year expenditure trends are reasonable proxies for ten-year funding trends, we use expenditure data for this aspect of the analysis because more years of data are available. In addition, the outlays of the highway and mass transit trust funds are considered discretionary but the funding for them is considered mandatory, and those outlay projections are based on inflation adjustments that would be removed by the proposed legislation. Therefore, the historical data on discretionary outlays better reflect the universe of programs that the proposed change in baseline rules would affect.

Can Spending Be Frozen Without Changing Policies? The Case of the Pentagon

Defense outlays in 2000 totaled $295 billion, just slightly more than at the height of the Reagan defense buildup in 1987. But despite almost the same level of *nominal* spending in 2000 as in 1987 (i.e., the same level of spending without adjustment for inflation), the number of active-duty military personnel fell from 2.2 million to 1.4 million during this period (a 36 percent reduction), the number of Navy ships fell from 569 to 315 (a 45 percent reduction), the number of Air Force fighter wings (active and reserve) fell from 38 to 20 (a 46 percent reduction), and the U.S. military closed more than 900 facilities around the world and 97 major bases in the United States.*

Why did these reductions — which virtually all policymakers would agree represent a significant change in defense policy — occur when the dollar level of appropriations was slightly *higher* in 2000 than in 1987? The answer is that *real* defense spending (spending after adjustment for inflation) declined nearly one-third over these 13 years, in the aftermath of the demise of the Soviet Union and the end of the Cold War. In discretionary programs, maintaining current policies generally entails staying even with inflation.

* House Armed Services Committee, "Defense Accomplishments of the 104th, 105th, and 106th Congresses," November 18, 1999; Department of Defense, *Annual Report to the President and the Congress.*

Retaining Inflation Adjustments Produces a Reasonable Benchmark Against Which to Measure Program Growth or Shrinkage

Inflation is a real phenomenon; as prices rise, the value of a dollar shrinks. Consequently, the amount of goods or services that a dollar could buy last year is greater than what it can buy this year or will be able to buy ten years from now. If, as H.R. 3578 proposes, discretionary programs are projected to be frozen for ten years, the baseline would be a benchmark that builds in real — and deep — cuts in federal programs. The box on this page regarding the defense budget vividly illustrates this point.

Such a practice also would stand in contrast to budgeting practices for the rest of the federal budget. Key features of the tax code as well as major entitlement programs are indexed for inflation each year.

To be sure, a simple inflation adjustment may not always be the ideal way to create a neutral benchmark. Many programs and most administrative costs should be adjusted to account for changes in program caseloads. The number of elementary school children will grow slightly over the next decade while the number of elderly people will grow rapidly. These facts may suggest that some programs should be adjusted both for inflation *and* for the growth of segments of the U.S. population; if not, the benefits or services per person will likely erode over time.[2]

[2] In fact, existing baseline rules instruct OMB and CBO to take caseload growth or shrinkage into account when projecting the administrative costs of the Medicare and Unemployment Compensation trust funds. But many other programs beyond those two are (or should be) responsive to changes in caseload. Needless to say, the proposed legislation, by establishing a strict freeze as its baseline projection rule for appropriations, would remove this feature of existing baseline rules as well.

But even if the inflation-adjusted baseline is not a perfect benchmark because it ignores population growth where that is relevant, it is much more likely to approximate the funding levels needed to maintain the same overall levels of goods and services than a baseline that ignores inflation.

It's also useful to ask whether building inflation into the discretionary baseline was responsible for current or future deficit and debt problems. Analysts across the political spectrum have concluded that the single largest factor behind the long-run threat to fiscal sustainability is the projected continuation of the 40-year trend in which per-person health care costs grow faster than the economy.[3] Although the Affordable Care Act begins to reform health care payment and delivery systems, substantial further steps will be needed to slow the growth of per-person health care costs and produce the degree of improvement that the long-term budget picture will need. The Bush tax cuts of 2001 and 2003, if made permanent in whole or in substantial part, also will add markedly to the long-term fiscal gap.[4] In contrast, discretionary appropriation and spending levels, which are projected to fall substantially as a share of GDP, are not a contributing factor here.

Thus, the long-term fiscal problems the nation faces do *not* stem from the level of annual appropriations. Moreover, it is extremely unlikely than the nation will cut annual appropriations by anywhere close to enough to cover the revenue losses from making the Bush tax cuts permanent, and it is virtually impossible to cut annual appropriations enough to cover the projected growth of health care costs in future decades (unless the Affordable Care Act proves more successful in containing costs than even its proponents hope).

Conclusion

Under current baseline rules, projections of appropriations tend to understate the amount of funding that Congress ultimately has chosen to provide. They also generally understate the amount of funding that is needed to hold the real level of per-person government benefits and services

[3] CBO, *Long-Term Budget Outlook, 2011:* "Spending for health care in the United States has been growing faster than the economy for many years, posing a challenge not only for the federal government's two major health insurance programs, Medicare and Medicaid, but also for state and local governments and the private sector. Measured as a percentage of the nation's gross domestic product (GDP), total spending on health care services and supplies increased from 4.8 percent in 1960 to 9.8 percent in 1985 and 16.5 percent in 2009, the most recent calendar year for which data are available. Federal spending for Medicare and Medicaid rose from 2.2 percent of GDP in fiscal year 1985 to 5.5 percent in 2010. Underlying those trends, health care spending per person has grown faster than the nation's economic output per person by an average of a little less than 2 percentage points per year during the past several decades. Key factors contributing to that faster growth have been the emergence and increased use of new medical technologies, rising personal income, and the expanding scope of health insurance coverage. Such rates of growth cannot continue indefinitely, however, because if they did, total spending on health care would eventually account for all of the country's economic output — an implausible outcome." http://www.cbo.gov/ftpdocs/122xx/doc12212/06-21-Long-Term_Budget_Outlook.pdf, pg. 35.

[4] We estimate that permanently extending the 2001 and 2003 tax cuts would add almost 2 percent of GDP to the long-run fiscal gap; that is, a continuation of these policies would increase deficits by almost 2 percent of GDP on average in future years, not counting interest. See *The Long-Term Fiscal Outlook Is Bleak Restoring Fiscal Sustainability Will Require Major Changes to Programs, Revenues, and the Nation's Health Care System,* Center on Budget and Policy Priorities, December 16, 2008, http://www.cbpp.org/cms/index.cfm?fa=view&id=2215.

constant from year to year. Removing inflation adjustments from the baseline rules would exacerbate these two understatements.

Baselines are not intended to be predictions of likely outcomes but are often used this way, and understating future deficits and debt would likely weaken fiscal discipline. Moreover, understating the total amount of funding needed to hold the real level of per-person benefits and services constant would make the baseline far less useful as a neutral benchmark against which policymakers and analysts can assess proposed funding levels.